Supreme Court of the United States

OCTOBER TERM, 1940.

MARJORIE FLEMING LLOYD-SMITH,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

The citations of the opinions below, the basis of the jurisdiction of this Court, and the question presented are set forth in the attached Petition, and are therefore not repeated here.

Specifications of Error.

The United States Circuit Court of Appeals erred:

(1) In holding that the $70,000 note of Jorwil Corporation was "other property" within the meaning of Section 113 (a) (6) of the Revenue Act of 1932, rather than a "security" within the meaning of Section 112 (b) (5) of said Revenue Act;

(2) In holding that the petitioner's substituted cost basis of the said $70,000 note of Jorwil Corporation was $70,000 rather than $386,458;

(3) In holding that the petitioner sustained no loss upon the sale of the said $70,000 note of Jorwil Corporation, rather than holding that the petitioner sustained a loss of $316,458 upon such sale; and

(4) In affirming the decision of the United States Board of Tax Appeals on this issue.

Argument.

It is not disputed that the exchange of petitioner's California assets for the stock and note of Jorwil Corporation was a transfer to a controlled corporation within the meaning of Subsection 112 (b) (5) of the Revenue Act of 1932. This subsection provides:

> "(5) *Transfer to Corporation Controlled by Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation * * *."

It is not disputed that, regardless of whether the Jorwil Corporation note is held to be a "security" as contended by the petitioner or "other property" as contended by the respondent, the cost basis of the petitioner's California assets is required to be allocated between the stock and note received in exchange therefor under the provisions of Subsection 113 (a) (6) of the said Act. This subsection provides:

> "SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.
>
> (a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—
>
> * * * * * *

> (6) *Tax-Free Exchanges Generally.*—If the property was acquired upon an exchange described in section 112 (b) to (e), inclusive, the basis shall be the same as in the case of the property exchanged * * *. If the property so acquired consisted in part of the type of property permitted by section 112(b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. * * *"

The only question before this Court, therefore, is the proper *method* of allocation of the cost of petitioner's California assets between the stock and the note of Jorwil Corporation received in exchange therefor—that is, the determination of the proper *proportions* of the total cost to be allocated to the note and to the stock, respectively. There is no problem of distinguishing a reorganization from a sale, and thus no problem of "continuity of interest."

If the Jorwil Corporation note was a "security" it is not questioned that the method of allocation used by the petitioner is proper, and that the cost of the $70,000 note would be $386,458 (*supra*, pp. 3, 4), and that the loss on the sale thereof at par would therefore be $316,458. The position of the respondent, sustained by the court below, is that the note is "other property" within the meaning of the above-quoted provisions, and that only an amount of the cost of the conveyed properties equal to the fair market value of the note at the time of the exchange, i.e., $70,000, can be allocated to it. Accordingly, the respondent contends that the sale of the note for $70,000 resulted in no loss.

Was, then, the Jorwil Corporation note a "security", or "other property", within the meaning of the above provisions?

I.

The decision of the Circuit Court of Appeals is in conflict with the decision of the Circuit Court of Appeals for the Ninth Circuit in *Burnham* v. *Commissioner.*

The decision below holds that an unsecured two-year corporate promissory note is not a "security" under Section 112 (b) (5) of the Revenue Act of 1932. It is submitted that this conclusion is in conflict with the *Burnham* case, *supra.*

In the *Burnham* case the taxpayer owned two unsecured promissory notes of a corporation, one for $402,500 and the other for $5,000, on which partial payments of $125,000 had been made. The notes were payable at the option of the maker at any time before their maturity, which was ten years from the date of issuance. These notes were exchanged by the taxpayer, within two years of the date of issuance, for stock of the issuer. The taxpayer claimed a loss on the transaction equal to the difference between the cost basis of the notes and the value of the stock received. The Commissioner of Internal Revenue denied the deduction on the ground that there was an exchange of "stock or securities" in a corporation a party to a reorganization, solely for "stock or securities" of such corporation, in pursuance of the plan of reorganization, and that on such a transaction no loss was realized under Section 112 (b) (3) of the Revenue Act of 1928.

Section 112 of the Revenue Act of 1928 was, in all respects material in the instant case, identical with Section 112 of the Revenue Act of 1932. Although the instant case involves a tax-free controlled exchange, while the *Burnham* case involves a recapitalization (reorganization), the terms and provisions applicable to both cases are for all practical purposes the same.

The taxpayer in the *Burnham* case argued that the term "security" included,

> "only more formal evidence of property, such as, long term series notes designed for distribution among investors, bonds, stock, and the like" (33 B. T. A. 149).

The Board of Tax Appeals and the Circuit Court of Appeals rejected this argument and held in favor of the Commissioner that the note was a "security."

The taxpayer applied to this Court for a writ of certiorari. The Commissioner, in opposing the application, stated in his Brief, at page 6:

> "The term 'securities', when used without qualification or restriction, as in the statute here involved, includes promissory notes—both in popular speech and in law. See *First National Bank* v. *United States,* 38 F. (2d) 925, 930 (C. Cl.), affirmed, 283 U. S. 142. The petitioner would give it a narrower and special meaning, but the language of the statute is to be read in its natural and common meaning. *Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552, 560."

This Court denied certiorari.

The Commissioner's position in the instant case is squarely in conflict with the decision in the *Burnham* case and with his position in opposing the petition for a writ of certiorari therein.

The fact that the term of the obligation in the *Burnham* case exceeded that of the Jorwil Note does not distinguish the cases, for this Court said, in *LeTulle* v. *Scofield*, 308 U. S. 415, 419; 60 Sup. Ct. 313; 84 L. Ed. 272 (1940), in discussing the classification of securities, that the term of the obligations is not material.

II.

The decision of the Circuit Court of Appeals is contrary to the decision of this Court in *Helvering* v. *Watts*.

In *Helvering* v. *Watts, supra,* there was an exchange of stock for $960,000 approximately of stock and $1,160,000 of mortgage bonds guaranteed by the transferee. Thirteen per cent of the bonds matured in five weeks, and the balance yearly thereafter in amounts of $150,000 approximately per year. Of the entire issue, approximately 40% had due dates of about two years or less, and the average maturity date for the entire issue was three years and three months. The Court held (a) that there was a reorganization and (b) that the bonds received were "securities" and not "other property", i.e., "boot",* so that no gain was realized on the receipt of either the stock or the bonds. The Court said:

> "It is also urged that an exchange of stocks for bonds results in a substantial change of position and that such bonds are 'other property' within the meaning of the statute and as such subject to tax. * * * The bonds, we think, were securities within the

* See on the meaning of "other property" or "boot" Paul and Mertens "Law of Federal Income Taxation", 1934, Sections 17.98, 17.102, 18.110.

> definition and cannot be regarded as cash, as were the short term notes referred to in *Pinellas Ice Co.* v. *Commissioner*, 287 U. S. 462."

The decision below, on the contrary, held that the Jorwil Corporation note, which had a maturity exceeding or equal to that of 40% of the obligations involved in the *Watts* case and two-thirds as long as the average maturity in the *Watts* case, was "other property" and not a "security."

It is submitted that such conclusion is contrary to the conclusion in the *Watts* case. While the obligations involved in the *Watts* case were secured and the note in the instant case was unsecured, this difference is not material. It has been held that in classifying securities a distinction based upon whether an obligation is secured or unsecured would not be reasonable. *Commissioner* v. *Tyng*, 106 F. (2d) 55, 59 (C. C. A. 2nd, 1939; reversed on another ground, 308 U. S. 527, 60 Sup. Ct. 378, 84 L. Ed. 309 (1940)).

The Circuit Court's sole basis of distinguishing the *Watts* case in the opinion below was the fact that the bonds there involved ran for a "considerably longer average period" than the notes in the instant case. It is submitted that such difference of one year and three months is not decisive, and that the *Watts* case is controlling here, in view of this Court's statement in the *LeTulle* case that, in classifying securities, the term of the obligations is not material.

As this Court found to be true in the *Watts* case, there was in the instant case no "substantial change of position". Because of the threatened attachment of the petitioner's California properties, she had simply changed the form of her investment therein. The Jorwill Corporation note

cannot be regarded as cash, for the assets of the corporation were non-liquid (R. 56-57), and the transaction was not a sale.

III.

The decision of the Circuit Court of Appeals, in holding that the doctrine of "continuity of interest" is to be applied in allocating cost basis to obligations received in a tax-free controlled exchange, is an unwarranted extension of the scope of decisions of this Court applying that doctrine and raises a novel and important question of Federal law which should be settled by this Court.

The Court in its decision below held that the Jorwil Corporation note was not a "security" because it did not represent the continuity of interest which the courts have found necessary to satisfy that term. For this conclusion the court below cited *Pinellas Ice & Cold Storage Co.* v. *Commissioner, supra, LeTulle* v. *Scofield, supra,* and *Helvering* v. *Tyng* and *Helvering* v. *Buchsbaum, supra.*

It is submitted that these cases do not involve the meaning of the term securities. They apply the doctrine of "continuity of interest", but for the purpose of distinguishing a tax-free reorganization from a taxable sale.

This Court first enunciated the doctrine of "continuity of interest" in *Pinellas Ice & Cold Storage Company* v. *Commissioner, supra.* That case involved a sale by one corporation to another of all its assets for a money consideration to be paid partly in cash and the balance in installments evidenced by short term promissory notes, the longest of which ran for only fifteen weeks. This Court said:

> "The court below held that the facts disclosed failed to show a 'reorganization' within the statu-

tory definition. And, in the circumstances, we approve that conclusion."

* * * * * *

" * * * the mere purchase for money of the assets of one Company by another is beyond the evident purpose of the provision, and has no real semblance to a merger or consolidation. Certainly, we think that to be within the exemption, the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes." (pp. 469-470)

This case did not hold that the short-term purchase money notes involved were not "securities." It held that the transaction was not a "reorganization" within the statutory definition, but was in fact a sale.

The doctrine of continuity of interest was later applied in *Helvering* v. *Minnesota Tea Company, supra,* and *John A. Nelson Company* v. *Helvering, supra,* and finally in January of 1940 this Court handed down its decision in *LeTulle* v. *Scofield, supra,* which defined the doctrine with great clarity. Shortly thereafter *per curiam* decisions on the authority of the *LeTulle* case were handed down in *Helvering* v. *Tyng* and *Helvering* v. *Buchsbaum, supra.*

These cases all involved the definition of the term "reorganization", in substance requiring that, before the nonrecognition provisions apply, the transaction must partake of the nature of merger or consolidation—that there must be a continuity of interest. Thus in the *LeTulle* case the Court referred only to Section 112 (i) of the Revenue Act of 1928, the section which defines the term reorganization for the purposes of that Act. *That section does not contain the term securities.*

None of the decisions of this Court relied upon in the opinion below purported to define the term "securities",

for the meaning of that term was not in issue. That is a question completely separate and distinct from the question arising under the definition of reorganization.

The dual nature of the reorganization provisions are well described in the government's brief in the Supreme Court in the *LeTulle* case. It was stated:

> "The question whether a reorganization occurred under Section 112 (i) (1) is a different question from whether bonds are securities under Section 112 (b) (3). In every reorganization case it is first necessary to determine whether there has been a reorganization within the meaning of the definition of Section 112 (i) (1). A determination that this definition is satisfied leads to the second question, whether the operative provisions which grant the exemption, e.g., Section 112 (b) (3), are applicable. In the *Watts* case it was only necessary to consider the stock in answering the first question, while here the answer to that question turns upon whether the bonds represent a sufficient continuity of interest to satisfy the accepted test" (p. 23).

In the instant case, involving a tax-free controlled exchange, the first question is non-existent. The tax-free controlled exchange provisions are applicable only to transfers where "control"* is retained, i.e., where 80% of the stock of the transferee is retained by the transferor. Here Congressional policy is clear. Congress itself has specified the nature of the interest necessary by itself defining "control". There is no need, therefore, for application of the judicial doctrine of continuity of interest. By its very nature a tax-free controlled exchange is akin to merger or consolidation. There is by necessity a continuity of proprietary interest. In the instant case the interest retained was 100%.

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* Section 112(j).

The sole issue in the instant case is the application of what were termed the "operative provisions" in the government's brief in the *LeTulle* case, to determine what proportions of the aggregate cost basis of the petitioner's assets transferred to Jorwil Corporation are to be allocated to the stock and note, respectively. The term "securities" has no significance in connection with the doctrine of continuity of interest, as applied in the above cases. The term "securities" is used in the "operative provisions" in contra-distinction to "other property" or "boot".

The error in the conclusion reached by the Circuit Court of Appeals in the decision below can perhaps be demonstrated more simply by stating a hypothetical case involving only one change from the facts of the instant case. Assume, for example, that the assets transferred to Jorwil Corporation had appreciated in value rather than depreciated in value, as was true in the instant case. The reasoning of the decision below, holding that the Jorwil Corporation note was "other property", or "boot", would require the imposition of a tax as a result of the exchange, on the difference between the transferor's cost basis of the property transferred and the fair market value of the stock and note, to the extent of the value of the note at the time of its receipt.*

The purpose of the intricate provisions relating to tax-free reorganizations and exchanges is to expedite and exempt from tax consequences corporate transactions which do not produce severance in any practical sense from the original capital investment, although the form of the investment may be changed (See Senate Report No. 275, 67th Congress, First Session (1924), House Report No. 350, 67th Congress, First Session (1924)).

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* Section 112 (c).

The purpose of the "other property" provisions is to deny complete exemption from tax in cases where money or other property having no direct relation to the assets conveyed, *i.e.*, "boot", is received in a reorganization or exchange. See *Groman* v. *Commissioner*, 302 U. S. 82 (58 Sup. Ct. 108, 82 L. Ed. 63, 1937) and *Helvering* v. *Bashford*, 302 U. S. 454 (58 Sup. Ct. 307, 82 L. Ed. 367, 1938).

The "other property" or "boot" provisions should have no application in the instant case.† The Jorwil Corporation note did not represent something materially different from what the petitioner had before the exchange. It was not like money, for the assets of Jorwil Corporation were frozen—nor like the Glidden stock in the *Groman* case, which represented an interest in assets having no direct relation to the assets conveyed. The taxpayer did not sever any part of her investment. She merely changed

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† The phrase "other property" has never been defined in the Revenue Acts or Regulations. The "other property" or "boot" provisions originated in substantially their present form in Section 202 (d) (1) of the Revenue Act of 1921, as amended by the Act of March 4, 1923. That section, as amended, was new in the law and the Report of the Ways and Means Committee of the 67th Congress, Fourth Session, House Report 1432 (Seidman's Legislative History of Federal Income Tax Laws, p. 803, 1938), explaining its introduction, referred to other property as "boot". The corresponding section of the Revenue Act of 1924 was Section 204 (a) (6), which is in all material respects identical with Section 113 (a) (6) of the Revenue Act of 1932. The Report of the Senate Finance Committee, 68th Congress, First Session, S. Report 398, pages 10 and 12 on Section 204 (a) (6) of the Revenue Act of 1924 (Seidman, *supra*, p. 700) discusses generally the purpose of the section, and, after stating that its provisions are so complicated that they can be explained only by examples, gives as an illustration of the application of the "other property" or "boot" provisions the example set forth in Article 597 of Regulations 77, p. 31 of Appendix A, herein.

It is significant that in the above Committee Reports, and in the Regulations to date, the only types of "boot" referred to have been cash and Government bonds. The Treasury Department has never issued a regulation to the effect that obligations of a transferee issued in connection with a tax-free controlled exchange constitute "boot".

its form, retaining a 100% proprietary interest. To say that the petitioner transferred her property to a wholly owned corporation and, simultaneously, took a part of it back as "boot", would seem to be illogical and unreasonable. It is submitted that the "other property" or "boot" provisions would not be applied and a tax imposed under the facts of the instant case had there been a gain, and there is no logical reason for their application in the instant case where there was a loss.

IV.

The decision of the Circuit Court of Appeals, in holding that a two-year corporate note is not a "security" under the tax-free controlled exchange provisions, raises a novel and important question of construction of Federal law which should be settled by this Court.

The term "securities" was not defined in the Revenue Act of 1932, or the Regulations thereunder, nor in any prior act or Regulations. In the absence of a definition, the language of a statute is to be read in its natural and common meaning (*Old Colony Railroad Co.* v. *Commissioner*, 284 U. S. 552 (1932)), and the natural and common meaning of the term "security" indisputably comprehends promissory notes. Thus Webster's New International Dictionary defines the term as follows:

> "That which secures or makes safe. Specif: Something given, deposited, or pledged, to make secure, or certain the fulfillment of an obligation, the payment of a debt, etc.
>
> Specif: An evidence of debt or of property, as a bond, stock certificate, or other instrument; a docu-

> ment giving the holder the right to demand and receive property not in his possession."

Abbott's "Dictionary of Terms and Phrases used in American or English Jurisprudence" (1879), contains the following statement:

> "Securities (plu.) is in use as a general term for written assurances for payment of money; evidences of debt."

Anderson's "A Dictionary of Law" (1893), contains the following definition:

> "Securities. Written assurances for the return or payment of money; evidences of indebtedness."

The Bureau of Internal Revenue, in an early ruling based upon an extended analysis of the authorities, concluded that, in the absence of a definition in the statute requiring a special or restricted meaning, the term "securities" included promissory notes in popular acceptation (GCM 2000, VI-2 C.B. 248 (1927)). In GCM 3291, VII-1 C.B. 203, published in 1928, the General Counsel of the Bureau of Internal Revenue ruled, again in the absence of a definition in the statute, that where stock was exchanged for stock and three months debenture notes of the transferee, the debenture notes were securities and the cost of the stock transferred should be allocated to the stock and notes received in proportion to their respective market values. This is precisely the position taken by the petitioner in the instant case. Again in the absence of a definition in the statute, the Treasury Department defined the meaning of the phrase "stock or securities" as used in Section 351(b) of Title 1A of the Revenue Act of 1934, imposing the Surtax on Personal Holding Companies, as

including "* * * bonds, debentures, certificates of indebtedness, notes * * *" (Regulations 86, Article 351-2(5)).

Subsequent to 1932 Congress itself repeatedly defined the term "security" as including promissory notes (Securities Act of 1933, Section 2(1); Section 23(k)(3), R. A. of 1938; Section 215(a) of the R. A. of 1939, amending Section 22(b)(9) of the Internal Revenue Code; Supplement R to the Internal Revenue Code, Section 373 (f); Section 3672 of the Internal Revenue Code.

Further examples of definitions and interpretations of the term "securities" by lexicographers, the Bureau of Internal Revenue, Congress and the courts could be given, but the foregoing make it perfectly clear that the term "securities" includes promissory notes both in common parlance and in law, and further, that when Congress intends to use the term in a special or restricted sense, it provides an express definition for the guidance of the taxpayer and the courts.

V.

An authoritative determination by this Court of the question whether a promissory note may be a "security" for the purposes of the tax-free controlled exchange provisions is important to a proper administration of the Revenue laws.

Congress has continued in the Revenue Acts subsequent to 1932 and in the Internal Revenue Code, provisions corresponding to the exchange provisions of the Revenue Act of 1932 applicable in the instant case. The question whether a promissory note may be a security for the purposes of such provisions is thus a question of continuing importance.

At the present time, because of the unsettled status of the law, the Treasury Department is forced to argue both sides of the question, thus increasing greatly the expense of administering the tax laws. An equal burden is imposed on the many taxpayers who have given or received corporate notes in connection with exchanges, recapitalizations and reorganizations.

For example, in *Hoagland Corporation* v. *Commmissioner, supra* (decided June 7, 1940; on appeal by the taxpayer to the C. C. A. 2nd), the taxpayer owned all the stock and a demand promissory note of a second corporation. There was a reorganization of the latter corporation under Section 77B of the Federal Bankruptcy Act. The taxpayer surrendered its stock and the demand promissory note and received in exchange therefor stock of the reorganized corporation.

The taxpayer claimed a loss as a result of the above exchange. The Commissioner of Internal Revenue denied the deduction on the ground that there had been a reorganization. The Commissioner of Internal Revenue relied primarily upon the *Burnham* case, *supra,* stating in his brief before the Board:

> "In the *Burnham* case the unsecured promissory notes were dated in 1927 and due 'on or before 10 years after date', and the exchange took place in the year 1929. In the instant case the unsecured demand promissory note was dated in 1928 and the exchange took place in 1935. There appears to be no sound reason to arrive at a different tax result in the instant case than in the *Burnham* case. The note holder in the instant case merely exchanged its interest in the corporation to that of a stockholder which was the essential situation that existed in the *Burnham* case" (p. 17).

The Board sustained the Commissioner, holding that there had been an exchange of "stock or securities" in a corporation a party to a reorganization, solely for "stock or securities" of such corporation, in pursuance of the plan of reorganization.

The question whether a corporate promissory note is a "security" is of continuing importance for the Revenue Acts subsequent to that of 1932 and the Internal Revenue Code contain provisions identical with those involved in the instant case. The difficulty of the question was adverted to by this Court in *LeTulle* v. *Scofield*, 308 U. S. 415, 420.

It is submitted that a review by this Court of the instant case will eliminate such doubt and uncertainty, and the resulting burden of litigation, both for the Treasury Department and taxpayers.

Conclusion.

For the foregoing reasons the decision of the Circuit Court of Appeals should be reversed.

Respectfully submitted,

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